the Commission's proposal to permit, but not require, rate-of-return LECs to establish a call set-up charge on a per-call basis, to be assessed on IXCs as described in paragraph 59 of the Notice. USTA agrees that only signalling costs should be recovered through call set-up charges.

C. The Commission Should Retain A Per-Minute Transport Interconnection Charge While Limiting Changes To The Other Transport Elements

The TIC should not be moved into the common line pricing structure for rate-of-return LECs. Instead, for rate-of-return LECs, the residual TIC should continue to be recovered on a per-minute basis, at least until further consideration by a joint board. Doing so would promote efficiency, universal service, and administrative simplicity.[49]

Because the TIC largely reflects the high cost of providing transport services in less densely populated areas,[50] it makes little economic sense to treat the TIC as part of common line costs. Indeed, as noted above, even with the introduction of SLCs and PICCs based on those required for price cap LECs, reduction of CCL charges will be a lengthy process. By requiring the common line rate structure to recover the TIC as well, remaining distortions in common line cost recovery will be exacerbated.

49/ The Price Cap Access Order required rate-of-return LECs as well as price cap LECs to reallocate certain costs from the TIC to rates for some facilities-based elements. *See* Price Cap Access Order ¶¶ 217-223. The Commission has noted that rate-of-return LECs would have to create some of these rate elements, and is aware of the expense and difficulties of modifying billing systems. *See id.* ¶ 215. In light of these practical difficulties and the nature of the TIC, USTA recommends that allocations to these rate elements be made optional for rate-of-return LECs.

50/ *See id.* ¶ 224-225.

If the costs associated with the TIC were treated as common line costs, pressures also would increase to require end users to pay, through SLCs and flat-rated charges related to the PICC, directly for the residual TIC, contrary to universal service goals of affordability and access.

More generally, rate-of-return LECs are in a different situation than price cap LECs with regard to decreasing the TIC. The Commission has required price cap LECs to target their price reductions arising from the price cap formula to reducing the residual TIC until it is eliminated. This is not possible for rate-of-return LECs, because there is no such annual reduction factor that applies to them.

Nor should the costs associated with the residual TIC be spread proportionately over all transport services.[51] As the Commission found in the Price Cap Access Order, some of the costs recovered in the TIC may be related to services other than transport.[52]

For LECs that participate in the NECA pools, moving the residual TIC to the common line category would cause substantial administrative difficulties. For LECs that belong to the common line pool but not the TS pool, questions arise as to how much of their TICs will be accepted into the common line pool once the TICs of other pooling LECs are transferred to the common line pool.[53]

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[51] *See* Notice ¶ 72.

[52] *See* Price Cap Access Order ¶ 241.

[53] *See* Notice ¶ 70 (proposing to "put into place a process that will, at different times for different rate-of-return LECs, begin the process of transitioning TIC costs to other rate elements").

Because of these factors, for rate-of-return LECs, the residual TIC should continue to be recovered on a per-minute basis, until further consideration by a joint board resolves the underlying separations issues.[54]

USTA also opposes proposals in the Notice to require rate-of-return LECs to establish several tandem-switched transport rate elements to recover, *e.g.*, costs of trunk ports used to terminate dedicated trunks on the serving wire center side of the tandem switch, as well as multiplexing elements to recover the costs of multiplexers associated with tandem switches that were reassigned to the tandem switching category from the TIC.[55] It is unclear whether such rate elements would actually result in more efficient cost recovery, particularly if LECs use the "surrogate" rates that the Commission proposes for these elements in the name of administrative simplicity. Yet developing the actual rates associated with these elements would be very burdensome to rate-of-return LECs. USTA recommends that such rate elements and surrogate rates be optional for rate-of-return LECs.

USTA supports the Commission's proposal to continue the existing rate structure for Signalling System Seven ("SS7") costs recovery by rate-of-return LECs, with an optional rate structure to reflect the rate structure for SS7 approved by waiver for Ameritech.[56] Doing so will add to the ability of rate-of-return LECs to offer such services efficiently.

54/ USTA recognizes that separations changes may not fully resolve all TIC issues.

55/ *See* Notice ¶¶ 67, 68.

56/ *See id.* ¶¶ 75, 77.

III. PRICING FLEXIBILITY IS ESSENTIAL FOR RATE-OF-RETURN LECS

Because of their relatively high costs, rate-of-return LECs face fundamental difficulties in competing with new entrants that seek to attract high-volume business users in the incumbent LECs' service territories.[57] As discussed in the SPR Affidavit, pricing flexibility must be available to permit rate-of-return LECs to respond to the competition that they face even today. Pricing flexibility helps ensure recovery of the fixed costs of the public switched network, while enabling rate-of-return LECs to respond efficiently to customers' needs that otherwise would not be met.[58]

The revisions to the access charge structure discussed above, while properly balancing cost-causation and universal service principles, also introduce additional rigidity into the access structure that could have anticompetitive effects. Indeed, by permitting competitive entry into the service territories of rate-of-return LECs, the 1996 Act has placed substantial pressures on the traditional forms of regulation that have been imposed pervasively on these LECs. The limited regulatory relief available to some rate-of-return LECs under sections 251(f)(1) and (2) of the Act will not resolve such issues.[59] As the SPR Affidavit shows, such relief is not a major factor in realizing the benefits of competition.[60] In fact, such measures are limited and transitional at best, and are designed to provide time for eligible LECs to adjust to the conditions created by the 1996 Act while allowing for the types of reform and rate rebalancing presented in USTA's plan.

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[57] *See id.* ¶ 44.

[58] *See* SPR Affidavit at 10-12.

[59] *See* Notice ¶ 12.

[60] *See* SPR Affidavit at 12.

The Commission can best address these issues by permitting modest pricing flexibility for rate-of-return LECs. Such flexibility should be introduced in specific common line and transport rate elements. Doing so will help ensure that competition will develop efficiently, as contemplated by the 1996 Act.

A. Pricing Flexibility Is Needed For Common Line Elements

Consistent with the foregoing, USTA recommends that the Commission permit zone pricing of SLCs, PICCs, and the CCL charge within each study area served by a rate-of-return LEC that has exited[61/] or does not participate in the pooled NECA common line tariff. The Commission should permit a reasonable number of geographic pricing zones for the LEC to apply in each study area, with rates for these common line elements to be averaged within each zone, but different among zones.

Common line zone pricing will permit rate-of-return LECs to reflect more closely the substantial differences in common line costs that may occur in different parts of their service territories, which may vary greatly in subscribership density, terrain, and the presence of residential versus business customers.[62/] Without zone pricing, study area-wide rate averaging would force rate-of-return LECs to price above costs in the areas where customers and traffic are concentrated, where competition is most likely to be intense. As the Commission found for Tier 1 LECs, this pricing umbrella could deprive customers of the

61/ As discussed below, USTA urges the Commission to permit LECs currently participating in the common line pool to exit the pool on an individual study area basis.

62/ *See* SPR Affidavit at 3, 5-9.

benefits of competition by preventing LECs from competing effectively, even when they are the most efficient providers.[63]

Recognizing the need to accommodate the Act's goals of universal service, competition, and efficiency, the flexibility proposed in the USTA plan for common line elements would be subject to limitations. Thus, the nationally averaged ceilings for SLCs and PICCs described in section II above could not be exceeded in any zone. Moreover, revenue foregone from lowering a zone price below the cap or ceiling level could not be recovered from universal service funding.

With respect to rate-of-return LECs that currently participate in the NECA common line pool, USTA recommends that the Commission remove its present requirement that a rate-of-return LEC in the NECA common line pool which elects to file its own carrier common line tariff must do so for all of the study areas that it serves.[64] Such a LEC should be permitted to file a common line tariff in individual study areas. Zone pricing as discussed above would be permitted within such study areas. This increased flexibility will permit LECs to address more directly the different market and service conditions that may exist in different parts of their service territories.[65] For individual study areas in which an otherwise pooling LEC files an individual common line tariff, the LEC would forego recovery of Long Term Support for that study area under the Commission's universal service rules.

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[63] *See Expanded Interconnection With Local Telephone Facilities*, 8 FCC Rcd 7341 (1993) at ¶ 98.

[64] *See* 47 C.F.R. § 69.3(e)(9); Notice ¶ 45. The Commission's rules allow rate-of-return LECs to exit NECA's TS pool on a study area basis, and many have done so. *See* 47 C.F.R. § 69.3.

[65] *See* SPR Affidavit at 16-17.

B. Pricing Flexibility Is Needed For Local Switching Elements

NECA introduced rate banding for local switching rate elements and the TIC in its tariff for the TS pool effective January 1, 1998. Rate banding helps move rates closer to costs, and gives a measure of pricing flexibility within the pooling environment.

To retain the flexibility permitted by such banding for rate-of-return LECs that file TS access tariffs for individual study areas, USTA recommends that a reasonable number of geographic pricing zones for local switching elements be permitted to apply in each such study area. Rates for these elements would be averaged within each zone, but would differ among zones.

As with common line elements, zone pricing for local switching elements on a study area basis will permit rate-of-return LECs both to respond to competition as it develops in their service territories and also price access services closer to costs. USTA proposes that such zone pricing be subject to the limitation of being revenue neutral within each study area.

IV. THE FCC SHOULD ADOPT IMPROVED FORMS OF REGULATION FOR RATE-OF-RETURN LECS TO ADDRESS COMPETITION

USTA urges the Commission to consider improvements to its regulation of rate-of-return LECs as it adopts new access charge rules for them, in light of the new competitive challenges that these LECs are facing.[66] Doing so will provide substantially greater regulatory certainty for some rate-of-return LECs, their customers, and competitors.

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[66] Such improvements are warranted despite the Notice's statement that alternative forms of regulation for rate-of-return LECs will be considered at a later point in this proceeding. *See* Notice ¶ 5.

Improved forms of regulation in turn will help promote the investment decisions and business planning by rate-of-return LECs and others that will bring the benefits of the 1996 Act throughout the United States.[67]

As discussed above, reform of the access charge rules for rate-of-return LECs, if performed when universal service issues are resolved, can help bring the benefits of the 1996 Act throughout the United States. Improved forms of regulation can similarly provide incentives for rate-of-return LECs to take actions that will realize the goals of the 1996 Act while ensuring that telecommunications users in their service territories receive telecommunications services at reasonable rates.

Adoption of improved regulation together with access charge reform would continue the historically strong interest of the Commission and Congress in the territories served by rate-of-return LECs. Concerns over the effects of the 1996 Act on LECs serving rural areas led Congress to exempt these LECs from numerous interconnection, unbundling, and resale obligations of incumbent LECs[68] until (i) they receive a request for "interconnection, services, or network elements" and (ii) the relevant state regulatory commission terminates the exemption in that market according to factors specified in the Act.[69] LECs with less

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[67] USTA has previously advocated other forms of regulatory relief that continue to have merit, such as removal of the 50,000 access line limitation on subset 3 carriers eligible for the optional filing method of section 61.39 of the Commission's rules. Such relief continues to be warranted, although the alternative forms of regulation discussed in these comments more broadly satisfy the competitive and universal service issues facing USTA's members and the public.

[68] *See Implementation Of The Local Competition Provisions Of The Telecommunications Act Of 1996*, 11 FCC Rcd 15499 (1996); Order on Reconsideration, 11 FCC Rcd 13042 (1996); *vacated in part sub nom. Iowa Utilities Board v. FCC*, 120 F.3d 753 (8th Cir. 1997), *cert. granted sub nom. AT&T Corp. v. Iowa Utilities Board*, 118 S. Ct. 879 (1998).

[69] *See* 47 U.S.C. § 251(f)(1).

than two percent of the aggregate access lines in the United States may petition their state commissions to modify or suspend application of many of the Act's requirements regarding incumbent LECs.[70]

Regulation of rate-of-return LECs should be modified to permit them to address competition as it develops, at their election and consistent with the Act.[71] One means of doing so would be to permit a rate-of-return LEC to elect to open its network prior to receiving a bona fide request for interconnection, services, or unbundled elements by:

> (i) publishing a list of unbundled network elements ("UNEs") consistent with the Commission's unbundling requirements currently in effect in Part 51 of its rules, with prices for such UNEs that are reasonably related to prices for such elements offered by similarly situated incumbent LECs,[72] and
>
> (ii) committing to provide local number portability[73] to any competitive entrant in a timely manner consistent with a state commission's approval of an interconnection agreement between the non-price cap incumbent LEC and that entrant pursuant to section 252 of the Communications Act.

Once such a LEC notifies the Commission, the affected state commissions, and the public that it has taken these actions to open its network,[74] it would be permitted to engage

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70/ *See id.* § 251(f)(2).

71/ Because the viability and integrity of the NECA pools must be preserved, further planning with NECA and its members is essential to determine any adjustments in the pooling system that should be made to accommodate such elections.

72/ Such UNEs must be available to telecommunications carriers at the time of such publication.

73/ *See, e.g., Telephone Number Portability*, CC Docket No. 95-116, Third Report and Order, FCC 98-82 (rel. May 12, 1998).

74/ Notification to the Commission and the state commissions would include a copy of the published list of UNEs and a general description of compliance with the network-opening actions described above.

in tariffing and pricing of interstate telecommunications services on an individual case basis, and also be permitted to file contract-based tariffs for such services.

This form of regulation provides strong incentives for rate-of-return LECs to provide the UNEs and local number portability that the 1996 Act has found to assist the development of local exchange competition. At the same time, it provides rate-of-return LECs with additional flexibility to respond to competition as it develops for interstate services, including interstate access services.[75]

Alternatively, when a rate-of-return LEC has obtained a state commission's approval of an interconnection agreement under section 251 of the Act in a portion of its serving territory, the Commission should remove the LEC's interstate access rates from rate-of-return regulation within the area in which competition is established by the approved agreement.[76]

Decreased regulation would be appropriate for the interstate services of rate-of-return LECs subject to competition. USTA suggests that the presence of at least one competitor in the LEC's service territory and the existence of an approved interconnection agreement indicate that market forces will discipline the LEC's prices for interstate service. Accordingly, rate-of-return regulation should no longer be imposed on LECs subject to such competition.

75/ *See* SPR Affidavit at 12-13.

76/ *Cf.*, *id.* at 20-21.

V. OTHER CHANGES IN THE ACCESS CHARGE RULES SHOULD DEPEND ON THE CHARACTERISTICS OF RATE-OF-RETURN LECS

A. Further Changes In The Commission's Rules Should Not Burden Rate-Of-Return LECs

The Notice proposes several other changes in the Commission's rules that would apply current practices for price cap LECs to rate-of-return LECs. In general, USTA believes that such changes should not be made unless they specifically reflect the environment in which rate-of-return LECs operate and improve the ability of rate-of-return LECs to respond to the competition introduced by the 1996 Act.

Thus, USTA opposes the proposal in the Notice to modify section 69.307 of the Commission's rules to allocate General Support Facilities ("GSF") costs to the billing and collection category.[77] According to NECA data, a majority of USTA's smaller rate-of-return members do not use general purpose computers to provide billing and collection services. Rather, more than five hundred rate-of-return LECs contract for billing services, and thus do not have costs related to billing and collection services now included in GSF. The proposed allocation would result in under-recovery of costs by these carriers.

Moreover, this proposal patently violates revenue neutrality. If additional costs were allocated to the billing and collection category from GSF or any other rate elements, recovery of these costs would not occur because billing and collection cost recovery is already limited by contract with suppliers of these services.

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[77] *See* Notice ¶ 82.

Nor should the Commission require rate-of-return LECs to recover their marketing expenses through the common line cost recovery mechanisms.[78] A portion of those expenses is already allocated to the common line revenue requirement. Common line costs of rate-of-return LECs are already so high that there is no public policy reason for loading additional marketing costs into the common line category.

The Commission should not apply PICCs to special access services offered by rate-of-return LECs.[79] When this measure was proposed for price-cap LECs, all commenting parties opposed it. To the extent that there are concerns that PICCs on multi-line business lines could lead to migration from switched access to special access services, imposing PICCs on special access will not address this problem. As discussed above, PICCs could well remain on the multi-line business lines of rate-of-return LECs longer than such lines of price-cap LECs. Even in this situation, the imposition of PICCs on special access would simply inject an unnecessary and artificial rate element into special access, without necessarily addressing any migration issue. The added burdens of administering special access PICCs would have no accompanying benefits.

USTA supports the Commission's proposal to adopt the streamlined waiver process of section 69.4(g) of the rules for rate-of-return LECs wishing to offer new services.[80] Because rate-of-return LECs often model their new service offerings after those already introduced by price cap LECs, a showing of prior approval of identical rate elements should not be limited to petitions granted to other rate-of-return LECs.

78/ *See id.* ¶ 86.

79/ *See id.* ¶ 90.

80/ *See id.* ¶ 95.

B. The Initial Regulatory Flexibility Analysis Does Not Fully Acknowledge The Market Position Of Rate-Of-Return LECs

With respect to the Notice's Initial Regulatory Flexibility Analysis, the Commission states that small rate-of-return LECs are either "dominant in their field or are not independently owned and operated," and thus are not considered to be "small entities " or "small businesses" for purposes of regulatory flexibility analysis.[81/] "Out of an abundance of caution," however, the Commission stated its intent to consider small incumbent rate-of-return LECs within this analysis. USTA would simply point out that, since the 1996 Act took effect, small rate-of-return LECs are merely incumbent in their service territories. As a general matter, competitors can enter any such territory at any time.

In describing the projected reporting, record keeping, and other compliance requirements of the proposals in the Notice, the Commission refers briefly to estimated costs of and resources needed for cost studies by rate-of-return LECs.[82/] The necessary cost studies would be extremely burdensome for all rate-of-return LECs, since the studies examine in detail the operations of the LECs' networks. Simplification of the access charge requirements and increased pricing flexibility are the best ways to decrease these burdens.

81/ *See id.* ¶ 103.

82/ *See id.* ¶ 111.

VI. CONCLUSION

USTA urges the Commission to defer making permanent changes in the access charge structure for rate-of-return LECs until after changes to the high cost support mechanism are complete. Any changes to the access charge structure should be accompanied by greater pricing flexibility for these LECs. The Commission also should adopt improved forms of regulation to permit rate-of-return LECs to address competition. If the Commission decides, nonetheless, to proceed before fully considering universal service issues, USTA urges the Commission to adopt the access plan for rate-of-return LECs presented in these comments. By doing so, the Commission will take an integrated and innovative approach to the changing circumstances in which rate-of-return LECs are operating today.

Respectfully submitted,

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Access Reform for Rate of Return Local Exchange Carriers: An Opportunity to "Get it Right"

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Executive Summary

The FCC's Notice of Proposed Rulemaking for access charge reform is an opportunity for the FCC to "get it right" for rate-of-return (RoR) ILECs. The FCC has appropriately laid the foundation for the need for access reform and pricing flexibility in the NPRM. The FCC recognizes that access reform may affect RoR ILECs differently than price cap ILECs. Nonetheless, the FCC proposes to impose the same rate structure on RoR ILECs and defers pricing flexibility. The FCC's proposal lacks the comprehensive approach necessary to access reform, universal service and pricing flexibility.

Central to this proceeding is the fact that RoR ILECs, most of which are rural ILECs, are different from price cap ILECs. We have studied rural ILECs and have identified a number of relevant differences between them and non-rural ILECs (primarily price cap ILECs). For example the average rural ILEC depends on access and universal service revenues for 61 percent of its total revenues. In contrast, the average non-rural ILEC receives about 34 percent of its revenues from access and universal service. This contrast is particularly important with regard to the recovery of common line costs. Consequently, the FCC must consider the impact of changes in access charges of RoR ILECs and should avoid sharp rate increases as a result of access restructuring, if those rate increases may be later reversed when universal service issues are resolved. As USTA recommends, if the FCC acts to establish SLC and PICC rates for RoR ILECs prior to the completion of the rural transition plan, it should cap the SLC and PICC for RoR ILEC customers at the nationwide average of price cap ILECs' rates to minimize the rate shock to customers.

As we discuss herein, pricing flexibility is an integral component of access reform, particularly as RoR ILECs face competitive pressures. USTA members have offered to unbundle their networks in return for the ability to provide access services via contracts. The FCC need not require unbundling by an RoR ILEC in order to grant pricing flexibility. RoR ILECs must be allowed to use alternative means to collect revenues to recover their networks' costs as lower-priced competitors challenge the viability of historical revenue sources. While pricing flexibility is not a substitute for universal service and access restructuring, particularly for high cost companies, the ability to price flexibly offers an additional means of interstate common line cost recovery for a number of RoR ILECs. If rates are allowed to rise according to the formulae used for price cap ILECs, recovery of such costs may become problematic. RoR ILECs are vulnerable to inefficient competition, to the extent that high common line costs are recovered through access charges that exceed those of price cap ILECs. Pricing flexibility is a means of reducing this vulnerability without excessive increases in local rates.

RoR ILECs should have the opportunity to de-average their common line rates among study areas through partial participation in the NECA common line pool, as USTA recommends. With accounting safeguards in place, partial participation in NECA pools enables an RoR ILEC to respond to different competitive pressures in different study areas. RoR ILECs should be able to de-average common line rates within study areas as well as to respond to different competitive pressures within a study area. RoR ILECs should be permitted to offer contracts and optional pricing plans for interstate access services to IXCs and to large customers. Contracts and optional pricing plans for large customers would include access rates related to the traffic the customer generates. Under this proposal, IXCs can compete for the customer by passing through the access discount. RoR ILECs' ability to offer contracts and optional pricing plans has the effect of rebalancing rates in an alternative fashion to the FCC's mandated rate restructure.

RoR ILECs often face lesser regulation before state commissions. Forbearance from the current level of regulatory scrutiny in an improvement over the current situation. While RoR ILECs may use pricing flexibility tools proposed by USTA to meet customer needs and respond to competition, standard tariff rates may serve as a cap on other rates. The pricing flexibility recommended is reasonable and appropriate for RoR ILECs. Pricing flexibility allows the market and costs to determine interstate access reductions, while not eliminating overall regulation of RoR ILECs' rates in contrast to rigid pricing rules. USTA's proposal considers the impact of competition, universal service and access reform on RoR ILECs and their customers.

I. Introduction

The Federal Communications Commission (FCC) has released its Notice of Proposed Rulemaking (NPRM) regarding access charge reform for rate-of-return incumbent local exchange carriers (RoR ILECs). The FCC has the opportunity in this proceeding to adjust rate structures and meet universal service needs at the same time that barriers to entry are removed in RoR ILEC markets by the 1996 Act.

The FCC has appropriately laid the foundation for the need for access reform and pricing flexibility in the NPRM. The FCC recognizes that RoR ILECs "need to be allowed to move their rates to more economically efficient levels," or risk the loss of customers to inefficient competitors with lower rates.[1] The FCC recognizes that access reform for RoR ILECs may raise different issues than for price cap ILECs[2] but advises that, unless it receives information which would distinguish RoR ILECs from price cap ILECs, it will impose the same rate structure on RoR ILECs that it developed for price cap ILECs.[3] The FCC defers pricing flexibility for RoR ILECs until a later phase in this docket.[4]

One issue about which the FCC seeks comment is the impact of the interconnection provisions of the Telecommunications Act of 1996 and the development of competition as they relate to the rate structure and the transition mechanism the FCC proposes.[5] All RoR ILECs fall into either rural ILEC or "two percent" ILEC status, or both, as described in the Telecommunications Act of 1996 (1996 Act).[6] Rural ILECs are exempt from compliance with the interconnection provisions

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1 *In the Matter of Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate of Return Regulation*, CC Docket No. 98-77, NPRM, released June 4, 1998 at ¶ 2.

2 NPRM at ¶ 4.

3 NPRM at ¶ 3.

4 NPRM at ¶ 5.

5 NPRM at ¶ 44.

6 Section 3(47) of the 1996 Act describes four criteria, one of which is to be met to be considered a rural telephone company: (1) provides common carrier service to any local exchange carrier study area that does not include either any incorporated place of 10,000 inhabitants or more, or any part thereof, or any territory, incorporated or unincorporated, included in an urbanized area; (2) provides telephone exchange service, including (continued...)

of Section 251(c) of the 1996 Act until the state commission decides otherwise. "Two percent" ILECs may receive suspension from or modifications of interconnection requirements upon a showing to the state commission.

While the FCC accurately recognizes the issues at hand, its proposal falls far short of meeting the needs of RoR ILECs by proposing to revise their rate structure in isolation of the other critical issues: competition and universal service. The FCC's proposal is especially perplexing since the NPRM discusses FCC actions thus far in its *Local Competition Order* and *Universal Service Order*, thus acknowledging the interrelationships among the three critical issues.

The RoR ILECs are generally those ILECs that are most dependent upon universal service mechanisms, from explicit funds to implicit rate structures. Appropriate action by the FCC is critical in this proceeding to enable these companies to adjust their pricing to meet customers' needs, to respond to competitive pressures and to maintain rate and service comparability with large urban markets. While exemptions and suspension/modifications are in the hands of state regulators, the FCC can and must address interstate rate rebalancing in consideration of the universal service impact for RoR ILECs. The FCC can achieve here what it did not achieve with respect to price cap ILECs; *viz.*, to restructure access rates *before* competition becomes widespread.

The FCC has an opportunity to "get it right" for RoR ILECs by restructuring access charges, resolving universal service issues and allowing pricing flexibility. Only if these policies are implemented in a coordinated fashion can the correct economic signals to encourage efficient competitors to enter the market be created. The FCC's restructuring of access charges for price cap ILECs improved economic efficiency and, if the FCC acts prior to the termination of the universal service transition plan, can be applied to RoR ILECs with some modifications as we will discuss. Pricing flexibility at the same time as barriers to entry are removed enables markets to operate efficiently and is in the public interest.

[6] (...continued)
exchange access to fewer than 50,000 access lines; (3) provides telephone exchange service to any local exchange carrier study area with fewer than 100,000 access lines; or (4) has less than 15 percent of its access lines in communities of more than 50,000 on the date of enactment. "Two percent" companies are defined as those with fewer than 2 percent of the nation's subscriber lines installed in the aggregate nationwide, according to Section 251(f)(2).

In this paper, we will discuss the impact of the FCC's proposed rate structure on RoR ILECs' ability to recover fixed costs of the network (*i.e.*, non-traffic sensitive costs), the need to rebalance rates, and the importance of granting pricing flexibility as they face competitive pressures.

Central to our discussion is the recognition that RoR ILECs *are* different from the larger price cap ILECs. ROR ILECs do have higher costs than price cap ILECs on average. In particular, RoR ILECs, primarily rural ILECs, are more dependent upon universal service and access revenues to cover their costs. Their customers have a smaller calling scope for local service than non-rural customers, and, hence, have greater toll usage than non-rural customers. These findings are based on our analysis of data regarding rural telephone companies, identifying several differences between them and non-rural companies.[7] We believe that these differences are also widely applicable to RoR ILECs that may not fit into the rural telephone company definition, but are "two percent" companies. Most (but not all) of these "two percent" companies primarily serve rural and outer suburban communities and have cost characteristics similar to rural ILECs. Because of the differences we found, the RoR ILECs' need pricing flexibility and a comprehensive approach to access reform and universal service, which are lacking in this NPRM.

II. Recovery of Fixed Network Costs

Recovery of fixed costs of the network has been the crux of the various universal service mechanisms. In particular, policymakers have sought to keep rates "affordable" in high cost areas and for residential customers. A number of services have thus been priced above cost to keep rural and residential rates below cost. Additionally, prior to divestiture, independent ILECs received settlement payments from AT&T. Following the arrival of long-distance competition and divestiture of the Bell System, an explicit high-cost fund was developed to achieve the recovery of network

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[7] We selected for our analysis study areas that met the rural telephone company definition of study areas containing fewer than 100,000 access lines and that set their access charges based on actual cost (rather than average schedule). Our study, however, does not include study areas over 100,000 lines that may qualify as rural companies through another criterion in the 1996 Act. We excluded some companies whose data were anomolous due to errors in reporting. Thus, our study includes 829 telephone companies. There are 1,051 study areas containing less than 100,000 access lines. Our sample includes a substantial majority of the RoR ILEC population. Our data sources were the ILECs' response to the FCC's Data Request in CC Docket No. 80-286 and NECA's most recent USF filing.

costs. Further, interexchange carriers (IXCs) paid newly-developed access charges for connection to ILECs' networks.

Access charges, like business and toll service prices, have been structured to make large contributions toward the fixed network costs. As competition has increased in telecommunications markets, the ability of this pricing scheme to enable recovery of the fixed costs of the network has progressively been reduced. Competition for above-cost services erodes the contribution they provide.

The element of access most important to the recovery of fixed network costs for RoR ILECs is the carrier common line (CCL) charge. The CCL, a per-minute charge, was designed to recover loop costs allocated to the interstate jurisdiction. The subscriber line charge (SLC) was then created to cover some of the common line costs up to a cap. The CCL covered costs beyond those recovered by the flat-rated SLC.[8]

In 1997, the FCC adopted a plan to eliminate the CCL charge in its access reform order for price cap ILECs. For price cap ILECs, the FCC developed scheduled increases in the SLC charges[9] and created the PICC, with offsetting decreases and eventual elimination of the per-minute CCL subject to various caps. The FCC estimated that, for many price cap ILECs, the CCL would be eliminated by 1999.[10] The FCC recognizes the obvious cost differences between RoR ILECs and price cap ILECs, noting industry estimates that the SLC for multi-line business may go immediately to the $9.00 cap if the same rate formulae are used for RoR ILECs.[11] USTA more recently has estimated that, under the FCC proposal, the SLC for multi-line business would immediately go to the $9.00 cap for a number of RoR ILECs without fully recovering the common line costs for those companies, and the CCL for those companies would not be eliminated by 2001.[12] This contrasts sharply with the FCC's expected elimination of the CCL for many price cap ILEC by 1999.

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8 A variety of universal service mechanisms have also contributed to common line cost recovery.

9 The SLC increases apply only to non-primary residential lines and multi-line business customers.

10 NPRM at ¶ 38.

11 NPRM at ¶ 36-40.

12 USTA Comments at 17.

Many differences between RoR ILECs and price cap ILECs are important to this proceeding, especially regarding common line rate restructuring. As we have discussed, RoR ILECs, which are primarily rural ILECs, have much higher costs than the price cap ILECs, which serve primarily urban and suburban areas.[13] Our analysis of rural ILECs shows that they obtain their revenues very differently than do other telephone companies. Rural ILECs are much more dependent upon access charge revenue than are other telephone companies. Our analysis indicates that rural ILECs, on average, obtain about 61 percent of their revenues from federal and state access charges and from universal service. Three-quarters of the rural ILECs in our study earn 50 percent or more of all their revenues from access and universal service. One-quarter of the rural ILECs in our study earn more than 70 percent of their revenues from access and universal service. In contrast, the average non-rural ILEC (primarily price cap ILECs) depends on access and universal service for only 34 percent of its revenues. Because reliance on contributions from access and universal service by rural ILECs is so great, the FCC must consider the consequences of these changes in access rate structures on these companies. In particular, the FCC should avoid sharp rate increases as a result of access restructuring, if those increases may later be reversed when universal service issues are resolved.

The pie charts below (Figures 1 and 2) illustrate the differences between rural ILEC and non-rural ILEC revenue sources.

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13 Citizens Communications, a price cap ILEC, is an exception as it serves primarily rural areas.

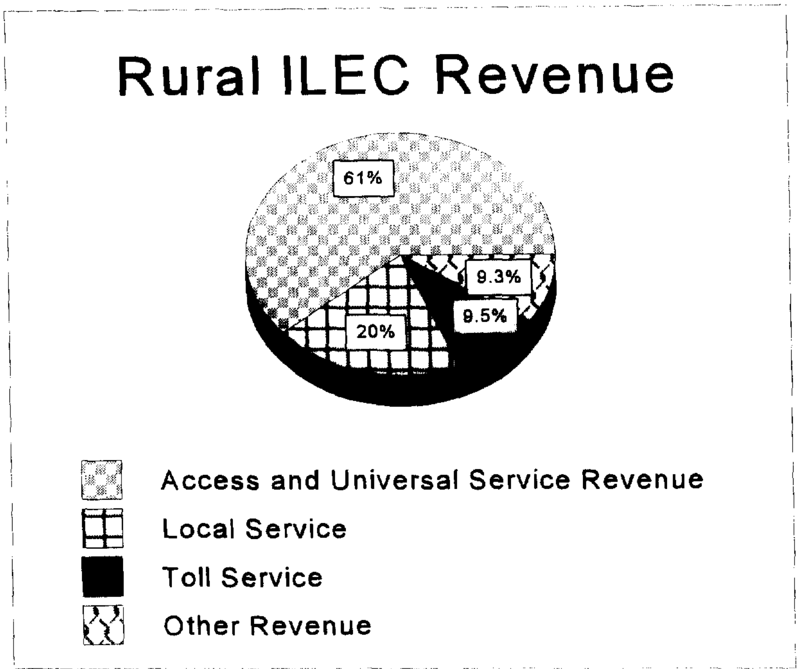

Figure 1

Figure 2

Shifting common line costs from the per-minute CCL to the flat-rated SLC and introducing the flat-rated PICC create a more efficient rate structure. Customers in RoR ILEC markets may benefit from this change to the extent that the IXCs pass through the access charge reduction. As the NPRM discusses, however, the effect of shifting cost recovery to end-user rates is more significant for RoR ILECs since their costs in general are much higher than those of price cap ILECs.[14] Our study of rural ILECs indicates that 55 percent of their total plant in service is cable and wire (*i.e.,* loops and interoffice trunks), while for non-rural ILECs, outside plant is 45 percent of total plant in service. Though both portions are significant, loop cost recovery is more essential to rural ILECs than non-rural ILECs. Additionally, because the SLC was capped at the same level for all ILECs, the amount and portion of RoR ILECs' common line costs recovered from the CCL are much greater than for the price cap ILECs. The rebalancing process proposed by the FCC consequently does not achieve the same results without universal-service contributions.

RoR ILEC customers have never directly paid common line costs reflecting the high costs in their rural areas beyond the capped SLC. To some extent they may be insulated from these high costs by the long-distance rate averaging requirements imposed on IXCs in the 1996 Act.[15] The consequence of setting the SLCs and PICCs with the formulae developed for the price cap ILECs would be the direct imposition of new, high costs on customers. Customers in RoR ILEC areas would have to pay significantly greater SLCs and PICCs than those in lower cost areas. Additionally, the SLCs and PICCs in RoR ILEC markets would be much higher than those in neighboring rural areas served by price cap ILECs. Price cap ILECs are able to average their rural and urban costs to achieve a lower average cost than RoR ILECs can generally achieve. While cost differences may reasonably occur, the impact of these resultant price differences can be significant if RoR ILECs are to increase their SLCs and PICCs according to the formulae for price cap ILECs.

Implementing the SLC and PICC rates as proposed by the FCC, prior to the resolution of universal service issues, will cause a rate shock to customers in RoR ILEC markets. If the FCC plans to revisit SLC and PICC charges when it addresses universal service for rural ILECs after

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14 NPRM at ¶ 36.

15 We do not know, however, whether rural customers are benefitting from all of the IXCs' optional calling plans. Further, customers in rural markets do not benefit from the presence of smaller, regional carriers that operate in only urban markets and can offer a lower average rate than the nationwide IXCs.